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ABSTRACT

This chapter reviews recent and emerging legal concerns in the increasingly varied and complex areas of group insurance, bond issuance, and annuity programs, each of which will impinge significantly on school operations in the years ahead, thus involving more staff and administrative time. Group insurance has developed into a major bargaining concern on account of the skyrocketing costs of health insurance. Accordingly, the Health Maintenance Organization (HMO) has arisen as a substitute for group insurance, but no employer is required to pay more as a result of HMO provision than is required by a prevailing health benefits contract. Other issues in group insurance include double coverage of married employees, taxable fringe benefits, and tax deferral strategies including board-paid teacher retirement, tax sheltered annuities, and deferred compensaion plans. The potential problems facing school districts as a result of the Tax Equity and Fiscal Responsibility Act of 1982 are discussed. This modification in the law, requiring bond issuance in registered form, will likely increase the bid price of a bond issue, the cost of printing bonds, and the transfer costs, while proposed modification in existing arbitrage rule will substantially reduce legal borrowing. Clearly, the costs in the area of group insurance and bond issuance are rising. (TE)

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Group Insurance, Bond Issuance and Annuity Programs

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Each of these subjects is broad enough to fill a book and then some. Thus, this chapter will be limited to some recent concerns in these areas and some newly emerging ones.

In each of these areas one can make three generalizations.

1) Each is more complex than it has been and each are becoming increasingly more complex.
2) Each raises more problems and more varied problems.
3) Each will impact significantly on school district operations in the years ahead and each will therefore involve more staff and administrative time.

Let us look first at Group Insurance. This area has developed into a major bargaining concern. Its importance has increased greatly as the salaries of school employees have escalated, particularly in the recent periods of great inflation. Often, higher salaries have generated only a larger tax bite by both the state and federal government. Simultaneously, the costs of health insurance have skyrocketed, particularly mental health costs. Add to this the impact of state and federal antidiscrimination legislation and medical cost containment legislation and one can see the basis of the increasing concerns in this area.

What then are some of the problems facing school districts in the group insurance area today? One problem in the health insurance area is the impact of the HMO or Health Maintenance Organization. The number of HMO's has increased dramatically in recent years as an alternative to the escalating costs of health insurance. HMO's vary greatly in the type of services they provide and the choices available to

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their members. Some allow a very limited choice of doctors and hospitals. These designate the person to provide the care and the location at which that care is to be provided. Others allow the user a wide selection of doctors as well as various hospital choices. Perhaps the largest user of HMO's today is the federal government who has initiated these programs in lieu of health insurance in most large metropolitan areas.

When must a school district offer a HMO? Under the Health Maintenance Organization Act of 1973, school districts were not required to provide this type of coverage (P.L. 93-22). Subsequently, Public Law 94-460 was enacted to require school districts to permit employee participation in HMO's in lieu of participation in the school district's group health insurance plan if: The school district offered a health insurance plan to employees; 25 employees live in the HMO service area; and application was made by the HMO to the school district. This application must be submitted in writing, must be directed specifically to the chief executive official of the public entity, and it must be received at least 180 days before the expiration or renewal date of a health benefit contract and at least 90 days before expiration of a collective bargaining agreement. State laws may mandate longer notice periods.

Public Law 94-460 does not specifically include school districts in the definition of "political subdivision" under section 110.801(c) of the regulations, but the officials responsible for implementing the regulations have adopted the position that the statutory mandate applies to school districts.

A HMO must be a "qualified HMO" to be eligible to participate in a school district program. Qualification is usually determined by the state department of insurance. In Illinois, however, this determination is made by the department of public health. One should check in their own state to determine the applicable governmental body charged with this responsibility. To date, the federal role in enforcement in this area is minimal.

There is one final problem relating to a school district's obligation to offer membership in a HMO. That problems involves the obligation of the employer to advise the collective bargaining representative in the district where employees are represented by such a representative, of the HMO request. If accepted by the bargaining representative, it must then be offered to each employee.

No employer is required by federal law to pay more for health benefits as a result of the provision of a HMO than is required by a

prevailing collective bargaining agreement or other health benefits contract.

A second issue in the group insurance area is the provision of double coverage where employees are members of the same household or an employee's spouse has superior coverage at another employer. This has recently became a major concern in several suburban Chicago school districts. The provision of double benefits really inures to the benefit of no one except the insurance company due to the coordination of benefits between companies. Frequently a district will attempt to provide two single coverages, thereby avoiding the great expense of dependent coverage. The obligation to provide dual coverage to employees is generally dependent upon the precise contract language. This is an area, however, where some school districts could save substantial sums of money or alternatively provide employees with more meaningful benefits.

A third area of concern in group insurance is the development of cafeteria fringe benefit plans. These plans permit employees to choose among a variety of benefits by establishing a fixed cost per employee for all fringe benefits. These have became increasingly popular as employees seek more benefits without taxable consequences. The usual items included in such packages are single and dependent health, vision, dental and prescription insurance, life insurance, disability insurance, tax sheltered annuities, tuition reimbursement, and coverage for out of pocket medical costs. Among the more exotic proposals are group automobile and homeowners insurance.

The proliferation of tax sheltered freebies has, of course, inspired the internal revenue service to seek to tax fringe benefits unless specifically excluded by Congress. The definition of "gross income" in the internal revenue code is extremely broad. "Gross income" is defined as all compensation, whether direct or indirect, monetary or "in kind" not specifically excluded by Congress.

Over the years this definition has been administered in a very haphazard fashion by the internal revenue service. When they attempted to tax fringe benefits in 1978, Congress clamped a moratorium on their authority to do so. This moratorium currently expires on December 31, 1983, but will, in all probability, be extended because Congress failed to adopt definitive and comprehensive legislation in the area.

House Resolution 3525 was introduced and provides for taxation of fringe benefits unless one of three exclusionary rules applies.

1) It is incident to the employers trade or business, the cost is insubstantial and it is provided on a nondiscriminatory basis.
2) It is provided primarily for the benefit of the employer rather than the employee.
3) If the benefits are insubstantial and it is not provided on a frequently recurring basis.

At least eight bills have been introduced to prevent the internal revenue service from taxing various fringe benefits. To date the final word on this issue has not been uttered; but, as the federal government looks for greater sources of revenue, this area must be considered a prime target.

How then can school employees shelter their income so as to prevent the government from taking such a big bite? There are three shelters which deserve at least some comment in view of their great attractiveness to defer taxes. These three are board paid teacher retirement, tax sheltered annuities and deferred compensation. Each of these can be used simultaneously, but threading one's way through the internal revenue code to assure compliance with its dictates may be more difficult than the proverbial camel getting through the eye of a needle.

One method of tax sheltering is through board-paid retirement. Under section 414(h) of the internal revenue code a board may pick up and pay an employee's contribution to a state retirement or pension program. The board's payment of this defers the income taxability of the contribution in the year it is made. Instead, the employee must treat this as income when it is received at retirement. This has become a frequently bargained item in recent years as it effectually increases the net pay of the teacher at the time the contribution is made. It may in individual circumstances, however, have extremely disadvantageous results for the employee. For example, if an employee quits teaching and these tax sheltered contributions are removed from the retirement system in a lump sum before retirement, the monies become taxable income at the time of removal. Because this could be a large sum of money it could easily propel a person in the 20 to 25 percent tax bracket into the 40 to 50 percent tax bracket. The consequences are obvious.

A second method of tax deferral is the utilization of tax sheltered annuities. Under section 403(b) of the internal revenue code employees may purchase tax sheltered annuities. This is frequently accomplished by means of a salary reduction from the participating employee's salary. These deductions are excludable from gross income in the year the contribution is made provided the sum contributed does not exceed a certain defined amount. The maximum amount which can be contributed is 20 percent of the employees income multiplied by the

number of years of service, less the "aggregate of the amount contributed by the employer for annuity contracts and excludable from gross income in any prior taxable year."

Finally, one can look to deferred compensation plans under section 457 of the internal revenue code. A deferred compensation plan may be established for employees of state and local governmental bodies. An eligible plan must meet the following requirements:

1) Only individuals who perform services for the local governmental body may participate.
2) The plan provides that compensation will be deferred for a calendar month only if the agreement providing for such deferral has been entered into before the beginning of the month.
3) The plan does not provide that amounts available under the plan will be made available before the employee is separated from service with the governmental entity or is faced with an unforseeable emergency.
4) The plan provides that all deferred compensation and property or rights purchased with such deferred compensation, and all income attributable thereto shall remain, until paid out, solely the property of the governmental entity and thereby subject to the claims of general creditors.
5) The plan establishes a specific ceiling on the amount of compensation which can be deferred.

It is imperative that any deferred compensation plan be reduced to writing and carefully reviewed by legal counsel to validate its compliance with the law.

The governmental entity may invest the deferred compensation sums with the permission of the employee. This would include investments in annuities or life insurance. If the governmental entity does invest these sums on behalf of an employee, the governmental entity is obligated to return to the employee only the current value of the investment. The employee thus bears all the risk in any deferred compensation plan. For example, if the governmental entity were to go bankrupt, the employee would be only a general creditor of the employer.

The maximum amount an employee may defer is the lesser of $7,500 or one-third of the employee's income. However, in an employee's last three years of employment, the employee may defer the lesser of $15,000 or any amount the employee could have deferred under the deferred compensation plan in prior years but did not, plus the normal amount which one could defer in the final three years.

Even from this brief description one can perceive the difficulty in reconciliation of the gross amount of income which can be deferred

under the various plans. Clearly, any deferred compensation plan contributions and tax sheltered annuity contributions must be taken together in determining the maximum amount which can be contributed in one year. It would also appear that board paid retirement benefits must also be included in this computation.

How does the school district, charged with withholding income tax of an employee, make the proper determination that it is withholding the proper amount of income tax? If excess contributions to a tax deferred plan are made, the deferral is invalid. There are serious penalties attributable to an employer who wilfully fails to withhold the proper amount of taxes. Generally, a miscalculation by the employer will not be treated as a wilful failure to withhold.

To protect a school district, the district should obtain a hold harmless agreement from the employee to the effect that the proper amount has been withheld and that the employee will indemnify the district for any tax, interest or penalties incurred by the district as a result of improper withholding. Perhaps a better alternative would be for the district to deal only with annuity companies who would execute a similar hold harmless agreement.

Finally, let us talk briefly about the potential problems facing school districts as a result of the proposed arbitrage rules issued by the internal revenue service and the new registration requirements required by T.E.F.R.A., the Tax Equity and Fiscal Responsibility Act of 1982. Each of these have an adverse impact upon the finances of a school district.

Under T.E.F.R.A., effective July 1, 1983, all debt obligations of governmental bodies must be issued in registered form as opposed to bearer form. This essentially requires that when a debt obligation is transferred to a new owner, a new certificate must be issued to the purchaser and the old certificate must be retired. Previously, the mere transfer of the bond certificate to the new purchaser was all that was required for transfer of ownership.

The widely circulated story for the rationale behind this change was that drug dealers, particularly in Florida, were using bearer bonds as a method of paying for drugs, because there was no record required of the transfer of bearer bonds. This provided a ready basis for payment with little of the attendant risks of cash. There does not appear to be any hard evidence, however, that this was actually occurring.

The result of this modification in the law has had some impact on the costs attendant to a bond issuance. It was initially believed that registration would add between 30 and 75 basis points to the bid price of a bond issue. This is somewhere between 1/3 and 3/4 of a percentage point. To date it is not clear that this price increase has occurred,

although it is generally believed that there has been some modest increase in the price governmental bodies are required to pay for bonds or other evidences of indebtedness that they sell.

The cost of printing bonds has generally increased as a result of this legislation. Bonds are now printed in essentially the same form as a stock certificate and interest coupons are no longer attached to the bond. In any issue where there is a likelihood that there will be a great number of subsequent transfers of the bonds, many more certificates for each maturity must be printed, as a new certificate must be issued upon each transfer.

The requirement to issue a new certificate upon each transfer generally requires the employment of a registration agent, *i.e.*, some bank or similar institution which will be responsible for safely maintaining unissued bond certificates and keeping a record of any transfers. This is a totally new cost which is becoming significant in the issuance of bonds.

The registration issue also suggests that there will be increased attempts by the United States Securities and Exchange Commission to adopt a greater role in municipal bond offerings. There have been inklings of this in the past, but the establishment of municipal bond offerings on a substantial par with private offerings increases this probability. If this does occur, there could be greatly increased costs attendant to a bond issuance if governmental entities are required to prepare the types of pre-issuance publications required in the private sector.

Let us turn now to another potential significant cost item for school districts. The internal revenue service has proposed significant modifications to the existing arbitrage rules. First, what is arbitrage? Arbitrage is the use of borrowed money to make money. Interest on most governmental bonds is exempt from federal taxation. However, obligations defined as arbitrage bonds are subject to taxation.

The purpose of the arbitrage rules is to ensure that governmental bodies do not borrow money needlessly, *i.e.*, that the purpose of a borrowing is not to accumulate capital to generate interest income. Under the present regulations, governmental bodies borrowing monies to meet cash flow purposes may borrow their anticipated cash shortfall plus one additional month's operating expenses. Under the proposed rules, this amount would be reduced to 105 percent of the cumulative cash deficit.

An example of the impact of this might help. In one Florida district, the cumulative deficit in the district last year was $650,000. Under the proposed rules, this district would be permitted to borrow a maximum of $682,500. By contrast, the monthly payroll expenditures in this

district alone are in excess of $12,000,000. Thus, the legal borrowing in this district has effectively been reduced by at least $11⅓ million.

The demands by governmental units to borrow funds to operate are increasing greatly nationwide with the uncertainty of real estate tax revenues. These rules will only serve to make it more difficult for districts in financial difficulties. These proposed rules also impose other new requirements. One relates to the necessity to include the yield on an acquired obligation held during a temporary period. The other requires that investment proceeds on acquired obligations be taken into account in determining whether the proceeds will exceed the amount necessary for governmental purposes.

Again, an example of the impact of this might help. If a district is going to issue bonds to construct a building which, for purposes of this example, we will assume will cost $10,000,000, the district must determine what interest it will earn on the capital funds received from the bonds issuance. Previously, most districts would have issued their bonds for approximately the $10,000,000 in question. Under these rules, the district must now issue bonds in a lesser amount to take into account the interest it will earn on the bond proceeds before they are paid out to contractors. The exact lesser amount will require a guesstimate of the interest that will be earned on the proceeds over the length of time the proceeds are held. For example, if the district guesses that interest rates will fall over the term the proceeds are held, the district will need to issue bonds in a greater amount than if it believes interest rates will remain constant or rise. However, if interest rates rise instead of fall, the district could be in an arbitrage situation because the district has not properly estimated the amount of income that would be earned. On the other hand, if interest rates fall when the district believes those rates would rise or stay the same, the district will have inadequate funds to meet the construction costs incurred.

Finally, there is one more item of concern in this area—Public Act 98-21, enacted in April, 1983. This act amended the social security law to provide that tax exempt interest must be taken into account along with other income in determining the amount of social security benefits to be taxed. Senate Bill 1113 has been introduced to repeal this act but its future is uncertain. Many feel that the inclusion of these interest amounts in social security determinations will force municipal bond interest rates upward to areas more in line with private issues.

Clearly, the prognosis for lower costs in the areas of group insurance and bond issuance are dim. School districts will continue to face more complicated areas of concern in these areas in the years ahead. Some say that "no news is good news." In these areas that may very well be true.